



UNITED NATIONS CONFERENCE
ON THE APPLICATION OF SCIENCE AND TECHNOLOGY
FOR THE BENEFIT OF THE LESS DEVELOPED AREAS

E/CONF.39/D/167
SUMMARY

7 Nov.1962

ORIGINAL : ENGLISH

SUMMARY

Agenda Item: D.1

United States of America

THE PROVISION OF ADEQUATE CAPITAL
FOR INDUSTRIALIZATION

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by

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SUMMARY

1. Provision of adequate capital for industrialization depends upon reasonable stability in those conditions which affect the prospective rate of return on capital. The foremost of these conditions are political stability and good government administration. There is no paradox in the fact that most investment is concentrated in developed countries with current rates of return less than those in less developed countries; the discount for risk and uncertainty accounts for most of the difference. This phenomenon is a consequence of rational calculation, not necessarily of differences between economic systems.
2. For foreign capital investment in less developed countries, the stability conditions have additional content. The prospective return on investment is dependent not only upon domestic stability in the recipient country but also upon stability of their exchange rates.
3. In addition to these general conditions, there are other indispensable conditions with respect to the supply and quality of the other factors which must be directly combined with capital to produce industrial goods. Of these, the most important is management, especially because management can overcome deficiencies in other factors. Finally, for successful use of capital in industrialization there must be an adequate supply of workers well enough educated, trained and motivated to perform the tasks assigned to them. Capital, management, labor and markets are as essential to successful industrialization as four legs to a horse. And, just as a horse may require a road to run with any speed, stable and efficient government providing a good investment climate is required if industrialization is to progress with reasonable speed.

Lessons from the Developed Countries in
Meeting Gaps in the Supply of Capital

4. Capital for industrialization consists essentially of three types:
(1) short-term loans for financing current operations, inventories, and accounts receivable; (2) intermediate and long-term loans (over ten years) for financing plant and equipment; and (3) equity capital, the permanent capital supporting the whole enterprise which also provides a margin of security for all types of loans.
5. Developing countries usually lack adequate institutions for providing either equity capital or longer-term loans to industry. Because the smaller and rapidly growing industrial firm is likely to predominate in such countries, and because such firms may be expected to encounter the most serious capital shortages, special attention to this type of financing is called for. What is very much required in the developing country, therefore, is a substitute for the capital market and its institutions, a substitute that performs the same economic functions. Such a substitute should, so far as possible, be a channel

linking the capital markets of developed countries and the capital supply of international agencies to the capital needs of developing countries. A type of institution to meet this range of financing needs is comparable to the special institutions which have been successfully pioneered already to fill the gaps in longer-term and equity financing in the developed countries. It is usually called a development bank.

Domestic vs. Foreign Sources of Capital

6. The possibilities of using foreign capital are limited by the capacity to generate foreign exchange. To use foreign capital for investments not related to such a purpose invites default on foreign obligations and the consequent drying up of the foreign sources of supply. Domestic, not foreign, sources are expected to supply the major part of the capital required for development.

7. Experience to date argues strongly for industrialization that clearly meets two requirements: (1) It uses capital most efficiently, which is best measured by projects yielding the highest discounted return over cost and (2) it fits into a total development program which will adequately meet the payments in foreign exchange entailed in its financing.

Economies of Scale and the Problem of Markets

8. There is a wide range of products that can be made in smaller plants serving limited markets. At the other end of the scale, certain manufactures are likely to be carried on only with very large investments and primarily for export. Examples are aluminum and copper. There is a wide range of other manufactured products which, to support optimum size plants, require markets far larger than those available in one developing country or even a contiguous group of them. The economies of scale require plants of such large size for many products that developing countries would have to form customs unions to justify their establishment if they wish to produce reasonably low-cost products. In these cases, nationalism is the enemy of efficiency.

9. Typically, the rate of interest from domestic sources in less developed countries for financing small undertakings is very high. Projects which are economically justified in the eyes of the foreign lender or investor may contribute far less to the productivity of the developing country, per unit of capital investment, than would equivalent investments in a number of small manufacturing plants able to earn the going rate of return in the developing country. To secure optimum size plants which will be competitive with foreign sources of supply, and to secure maximum returns from the limited supply of capital available to them, most developing countries would be well advised to establish development financing institutions which concentrate upon smaller plants capable of earning the high domestic rate of return on capital, particularly when foreign capital to finance such development financing institutions is available at relatively low cost.

10. The considerations discussed in this paper seem to demonstrate that conditions largely within the control of the developing countries would appear to determine whether larger supplies of capital can be made available and can be effectively used.